Response to NCUA Advance Notice of Proposed Rulemaking

March 26, 2009

Mary Rupp
Secretary of the Board
National Credit Union Administration
1775 Duke Street
Alexandria, Virginia 22314-3428

Dear Ms. Rupp:

First Alliance Credit Union is a $100 million state-chartered community credit union serving 11,000 members with 37 employees in southeastern Minnesota. First Alliance Credit Union appreciates the opportunity to comment on the role that corporate credit unions play in the credit union system, including corporate's membership structure, size and types of services they offer. At present we do business with two corporate credit unions: Corporate Central Credit Union in Wisconsin (we are not a member) and Member's United Corporate Credit Union in Illinois (we are a member.) Given the unprecedented losses caused by mismanagement of corporate credit unions to the natural person credit unions we believe this review is urgently needed and encourage the NCUA to act quickly on this matter so as to minimize future losses. In that spirit please consider the following comments:

- **The Role of Corporates in the Credit Union System**

    - Payment System: We currently utilize Member's United Corporate Federal Credit Union for a couple of payment services: member and third party domestic and international wire transfers and check collection deposits (and related image services). We have readily accessible and affordable alternatives to both plus the skills and experience necessary to perform these services in-house, through FedLine and/or other third parties. We believe many smaller credit unions are dependent on corporate credit unions for these services. The service associated with these services has declined significantly over the past five years as Member's United has focused on growth and mergers rather than serving the needs of its members.

      We don't believe that payment services need to have a separate charter but that they can be compatibly offered alongside investment services provided appropriate regulatory guidelines regarding capital and risk are established, followed and enforced.

- <u>Liquidity and Liquidity Management:</u>

  We do not rely on either corporate credit union for investment services and have full access to a variety of investment services outside of the corporate credit union network. We have found Member's United to offer lower than market rates on their settlement and overnight accounts as well as on their structured products. Because their rates are non-competitive we seek those services outside of the corporate credit union network and maintain only a target balance at the corporate to facilitate clearing and settlement services.

  We have an established line of credit with Member's United which is integral and critical to our liquidity planning and management. We also maintain a relationship with the Federal Home Loan Bank for liquidity management reasons. As we increase in size and look to shift more of our clearing and settlement relationship to the Federal Reserve Bank reliance on this service would likely decline. However, for the time being it is the only critical service in this relationship.

  Corporates should be required to set aside a portion of liquidity to specifically fund daily settlement. The set-aside must accommodate the timing of settlement of debits and credits as well as the daily, monthly, and annual cyclical activity levels.

  Improve the Central Liquidity Facility (CLF) – the CLF has proven to be an invaluable tool for the NCUA and for credit unions throughout the credit and liquidity crisis. Conduct a comprehensive evaluation of the CLF, remove legislative barriers and advocate for changes that improve it as a tool for use by the NCUA and the industry.

- <u>Field of Membership Issues:</u>

  We strongly believe that the NCUA bears some responsibility for the, albeit, unintended consequence of allowing corporate credit unions to have national fields of membership. It is plainly evident that those credit unions who continued to focus on the needs of their membership took fewer risks and provided better rates than those who spent their resources acquiring empire at the expense of safety and soundness.

  The trust we had in Member's United and their management team has been seriously eroded. We will, as expeditiously as possible, shift our relationships to the Federal Reserve Bank and Corporate Central in Wisconsin. We think that competition between corporates has been a good thing and we have benefited from higher rates as a result. We do not think membership in corporates should be mandated or required and that credit unions should be able to elect which, if any, corporate credit union to be part of. It is unlikely that the credit union industry, as it shrinks, needs 28 corporate credit unions. However, those corporate credit unions which acted imprudently and took on high risk investments and whole loans should not be rewarded by becoming the surviving institutions. As an industry, we have borne as much loss as we can tolerate and then some. Recapitalizing these failing institutions should not be mandated.

- Expanded Investment Authority

Some would argue that corporates are only allowed to purchase highly rated securities and have well-defined guidance for risk exposure. However, that has clearly not protected member credit unions from unprecedented losses. And, based on my observation the losses are concentrated in those credit unions given expanded investment authority.

Considering portfolio diversification is a fundamental concept of financial management is was surprising to learn that our corporate credit union had concentrations of greater than 65% in one asset class. Yet, their investment policy apparently allowed them to do so and oversight functions failed to detect this building risk. Furthermore, the whole loans that they purchased, while triple A rated, were investments with complex characteristics and high risk profiles which should have been apparent to even relatively inexperienced investment managers. It appears that the corporate credit union staff and management and the NCUA examiners auditing them lack the expertise, systems, processes and controls needed to utilize these expanded privileges effectively and soundly.

NCUA should definitely set more definitive guidance for required capital levels and capital requirements should be expanded commensurate with additional risks taken. It is not sufficient to assess whether the corporate credit union has the expertise in place to manage these complex investments it is also critical that the NCUA examiners have expertise in this area also so that they are not relying on the representations of management.

- Structure; Two-Tiered System:

We don't believe that a two-tiered system is required or prudent. If an organization is "too big to fail" because it poses too much systemic risk to the payment system, then it is too big to exist and should be broken up into smaller redundant, competitive components. The wholesale functions provided by US Central are easily replaced by third parties and the Federal Reserve Bank. In summary, the corporate system should be collapsed into a single tier. The present system is inefficient. To go to a single corporate model concentrates too much risk in one institution and would likely result in funds leaving the corporate system to seek an appropriate diversification of risk. The multi-corporate option is less efficient but it would also spread risk.

- **Corporate Capital**

  - <u>Core Capital</u>

    Core capital should be GAAP Tier 1 capital to include corporates retained and undivided earnings and perpetual paid-in capital (PIC). Core capital should be generated via undivided earnings. Corporates should not limit their services only to members maintaining contributed core capital particularly as it applies to investment and term products.

    Higher core capital is needed to accommodate changing views of risk and to meet the expectations of industry stakeholders. However, those corporate credit unions whose capital has been compromised due to poor investment elections should not benefit from absorbing those corporate credit unions that protected their core capital from such risk.

    The current requirement, actual capital divided by 12-month daily average net assets, accommodates fluctuations in assets due to seasonality. This should continue to be an appropriate method for measuring capital.

    We do not feel that corporates should be brokering deposits and/or investment services from other corporates. We feel this limits competition within the corporate environment and is costly to natural person credit unions. For the purposes of diversification natural person credit unions should be able to purchase investment and term products without becoming a member.

    Implementing risk-based capital regulation in a manner consistent with other federally regulated financial institutions is called for.

- **Permissible Investments**

    The NCUA should limit corporate credit union investment authorities to those allowed for natural person credit unions.

    The NCUA should prohibit non-agency collateralized debt obligations. They should prohibit net interest margin securities and non-agency sub-prime and Alt-A asset-backed securities.

    It is evident from their mistakes and the losses that they have generated that the largest corporate credit unions which were given expanded investment authorities lacked expertise in these markets and lacked an appropriate understanding of the market characteristics and risks associated with these investments. Their risk management infrastructure and expertise was insufficient for the complexities of the markets in which they were dealing.

- **Credit Risk Management**

Corporate credit risk practices and their corresponding regulation relied on rating agencies as the predominant metric for credit risk associated with investment securities. This provided a false sense of confidence to investment professionals who lacked a comprehensive understanding of the complexities of the investments in which they were dealing.

Fix the rating agencies: The financial services industry must require significant improvement in the rating agencies' performance. The agencies must maintain their independence and minimize conflicts of interest between agencies and issuers.

Practices could further be improved by requiring investment professionals to obtain ratings from multiple agencies or assigning greater weight to the lowest rating.

New limits and controls are essential. Member's United carried 65% of its investments in one asset class and the most risky at that. If this requires that a standard definition of sectors be created and applied consistently across all corporates then so be it. Diversification needs to be a corner stone of new guidance for corporates going forward.

Credit spread widening should be included as one of the risk parameters in the review of credit risk, and should be included in the reviews of interest rate and liquidity risk.

Corporates should be required to obtain independent, third-party evaluations of credit risk portfolios and they should be required to change providers of external reviews periodically.

- **Asset Liability Management**

Reinstate the requirement for modeling and stress testing net interest income. All corporates should model net income and NEV as part of their monthly risk modeling and monitoring processes. Furthermore, corporates should be required to model and test credit spread increases. All key risk processes should require external reviews and validation testing.

- **Corporate Governance**

  Currently each corporate maintains minimum qualifications for Board and Committee members. The NCUA should standardize these minimum qualifications across all corporates. The NCUA should require each corporate to maintain a training program commensurate with the activities of the corporate and should require documentation of same.

  The credit union industry is a tightly knit group with many interdependencies between CEOs of the largest natural person credit unions and the boards of the corporates. Term limits are essential. Corporates should have natural person credit unions represented on their boards. Outside directors, if utilized, should not outnumber directors from credit unions. Whatever standards are adopted should be uniform across the corporate system not determined individually by each corporate. The NCUA should set compensation thresholds for outside directors.

  Corporate compensation information for executive management should be disclosed in the annual report.

Thank you in advance for your consideration of these changes. If you would like to discuss any of the points we have raised, please feel free to contact me at 507-281-7602.

Sincerely,

Kelly McDonough

Kelly McDonough, CPA
President/CEO